



The Institute of Chartered Accountants in England and Wales

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Workbook

For exams in 2021

Financial Management

The Institute of Chartered Accountants in England and Wales

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Questions within the Workbook should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the Question Bank.

Welcome to ICAEW

I'd like to personally welcome you to ICAEW.

In a fast-changing and volatile world, the role of the accountancy profession has never been more important.

As an ICAEW Chartered Accountant, you will make decisions that will define the future of global business.

By choosing our world-leading chartered accountancy qualification, the ACA, you will acquire exceptional knowledge and skills - with technology and ethics at the heart of your learning. A focus on capabilities such as judgement and scepticism will enable you to make the right decisions in diverse and often complex environments.

You will be equipped to flourish and to lead in areas that are transforming the business landscape. This includes embracing technological change and harnessing digital disruption, to help our profession deliver greater value. It also includes putting climate change and sustainability at the heart of business strategy. We will equip you to be adaptable and agile in your work and all within a set of values fundamental to trust and transparency, which will set you apart from others.

Joining over 184,500 ICAEW Chartered Accountants and students worldwide, you are now part of a global community. This unique network of talented and diverse professionals work in the public interest to build economies that are sustainable, accountable and fair.

You are also joining a community of 1.8m chartered accountants and students as part of Chartered Accountants Worldwide - a family of leading institutes, of which we are a founder member.

ICAEW will support you through your studies and throughout your career: this is the start of a lifetime relationship, and we will be with you every step of the way to ensure you are ready to face the challenges of the global economy. Visit page [v](#) to review the key resources available as you study.

With our training, guidance and support, you will join our members in realising your career ambitions, developing world-leading insights and maintaining a competitive edge.

We will create a world of strong economies, together.

I wish you the best of luck with your studies.

Michael Izza

Chief Executive

ICAEW

Financial Management

If you are studying this exam as part of the ACA qualification go to icaew.com/examresources or if you are studying the ICAEW CFAB qualification go to icaew.com/cfabstudents.

Module aim

Financial Management enables students to recommend relevant options for financing a business, recognise and manage financial risks and make appropriate investment decisions.

On completion of this module, students will be able to:

- identify capital requirements of businesses, assess financing options and recommend relevant methods of financing;
- identify the financial risks facing a business and the principal methods of managing those risks; and
- apply appropriate investment appraisal techniques taking into account other factors affecting investment decisions.

Method of assessment

The Financial Management module exam is 2.5 hours long. The exam consists of three questions. Managing financial risk will be assessed as a discrete topic. The other two questions will assess financing options and investment decisions and valuation either as discrete or integrated topics.

Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will equate to the weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

	Weighting (%)
1 Financing options	35
2 Managing financial risk	30
3 Investment decisions and valuation	35

Permitted texts

At the Professional and Advanced Levels there are specific texts that you are permitted to use during your exam. All information for these texts is available on icaew.com/permitteditexts.

Professional level exams	Permitted text
Audit and Assurance	✓
Financial Accounting and Reporting	✓
Tax Compliance	✓
Business Strategy and Technology	x
Financial Management	x
Business Planning	No restrictions

Advanced Level exams	
Corporate Reporting	No restrictions
Strategic Business Management	No restrictions
Case Study	No restrictions

The exams which have no restrictions include the following:

- Business Planning: Banking;
- Business Planning: Insurance;
- Business Planning: Taxation;
- Corporate Reporting;
- Strategic Business Management; and
- Case Study.

This information, as well as what to expect and what is and is not permitted in each exam is available in the Instructions to Candidates. You will be sent the instructions with your exam admission details. They can also be viewed on our website at icaew.com/exams.

Key resources

Whether you're studying the ACA qualification with an employer, at university, independently (self-studying), or as part of an apprenticeship, we provide a wide range of resources and services to help you in your studies.

Take a look at the online exam resources available to you on icaew.com/examresources and discover more resources and services at icaew.com/studentbenefits.

Syllabus, skills development and technical knowledge grids

This syllabus presents the learning outcomes for each exam and should be read in conjunction with the relevant technical knowledge grids and, where applicable, the skills development grids.

Exam support

A variety of exam resources and support have been developed on each exam to help you on your journey to exam success. This includes exam guidance, sample exams, hints and tips from examiners and tutors, on-demand webinars and articles.

Past exams and mark plans

Use past exams to practise answering questions. The mark plans will help you check your answers. The past exams and mark plans are included in your Question Bank and have been updated to reflect the 2021 legislation and syllabus.

Errata sheets

These documents will correct any omissions within the learning materials once they have been published. You should refer to them when studying.

Exam software

It is vital that you are familiar with the exam software before you take your exam. Access a variety of resources, including the practice software and sample exams at icaew.com/studentresources.

Student support team

Our student support team is here to help and advise you, so do not hesitate to get in touch. Email studentsupport@icaew.com or call +44 (0)1908 248 250. If you are browsing our website, look out for the live help boxes. You will be able to speak directly to an adviser. Mia, our ChatBot, is also on hand to answer your queries.

Online student community

The online student community is the place where you can post your questions and share your study tips. Join the conversation at icaew.com/studentcommunity.

ICAEW Quarterly and Student Insights

As an ACA student, you will also receive a copy of our member magazine, *Quarterly*. Read more at icaew.com/insights.

You'll also be able to access our practical and topical student content on our dedicated online student hub, Student Insights.

You'll find new-look features, interviews and guides giving you fresh insights, innovative ideas and an inside look at the lives and careers of our ICAEW students and members. No matter what stage you're at in your journey with us, you'll find content to suit you.

Tuition

The ICAEW Partner in Learning scheme recognises tuition providers who comply with our core principles of quality course delivery. If you are not receiving structured tuition and are interested in doing so, take a look at ICAEW recognised Partner in Learning tuition providers in your area at icaew.com/dashboard.

CABA

It can be tough juggling your studies with work, planning for the future and finding time to unwind. CABA are an independent charity that supports the well-being of the chartered accountant community. So, if you need support at home or at work, CABA is there for you. They provide information, advice and lifelong support to ACA students across the world face-to-face, over the phone and online. All their services are completely free and strictly confidential. Find out more at caba.org.uk.

ICAEW Business and Finance Professional (BFP)

ICAEW Business and Finance Professional (BFP) is an internationally recognised designation and professional status. It demonstrates your business knowledge, your commitment to professionalism and that you meet the standards of a membership organisation. Once you have completed the ICAEW CFAB qualification or the ACA Certificate Level, you are eligible to apply towards gaining BFP status. Start your application at icaew.com/becomeabfp.

Skills within the ACA

Professional skills are essential to accountancy and your development of them is embedded throughout the ACA qualification.

The level of competency required in each of the professional skills areas to pass each module exam increases as ACA trainees progress upwards through each Level of the ACA qualification. The skills progression embedded throughout the ACA qualification ensures ACA trainees develop the knowledge and professional skills necessary to successfully operate in the modern workplace and which are expected by today's forward-thinking employers.

The following professional skills areas are present throughout the ACA qualification.

Skill area	Overall objective
Assimilating and using information	Understand a business or accounting situation, prioritise by determining key drivers, issues and requirements and identify any relevant information.
Structuring problems and solutions	Structure information from various sources into suitable formats for analysis and provide creative and pragmatic solutions in a business environment.
Applying judgement	Apply professional scepticism and critical thinking to identify faults, gaps, inconsistencies and interactions from a range of relevant information sources and relate issues to a business environment.
Concluding, recommending and communicating	Apply technical knowledge, skills and experience to support reasoning and conclusion and formulate opinions, advice, plans, solutions, options and reservations based on valid evidence and communicate clearly in a manner suitable for the recipient.

The following provides further detail on the professional skills that you will develop in this particular module. To see the full skills development grids, please go to icaew.com/examresources.

Assimilating and using information

Understand the situation and the requirements

- Demonstrate understanding of the business context
- Recognise new and complex ideas within a scenario
- Identify the needs of customers and clients
- Explain different stakeholder perspectives and interests
- Identify risks within a scenario
- Identify elements of uncertainty within a scenario
- Identify ethical issues including public interest and sustainability issues within a scenario

Identify and use relevant information

- Interpret information provided in various formats
- Evaluate the relevance of information provided
- Use multiple information sources
- Filter information provided to identify critical facts

Identify and prioritise key issues and stay on task

- Identify business and financial issues from a scenario
- Prioritise key issues
- Work effectively within time constraints
- Operate to a brief in a given scenario

How skills are assessed: students may be required to:

- absorb and understand both structured and unstructured material; and

- give recommendations based on their understanding and interpretation of the information provided, supported by explanation of the reasoning behind and implications of their recommendations.

Structuring problems and solutions

Structure data

- Structure information from various sources into suitable formats for analysis
- Identify any information gaps
- Frame questions to clarify information
- Use a range of data types and sources to inform analysis and decision making
- Structure and analyse financial and non-financial data to enhance understanding of business issues and their underlying causes
- Present analysis in accordance with instructions and criteria

Develop solutions

- Identify and apply relevant technical knowledge and skills to analyse a specific problem
- Use structured information to identify evidence-based solutions
- Identify creative and pragmatic solutions in a business environment
- Identify opportunities to add value
- Identify and anticipate problems that may result from a decision
- Identify a range of possible solutions based on analysis
- Identify ethical dimensions of possible solutions
- Select appropriate courses of action using an ethical framework
- Identify the solution which is the best fit with acceptance criteria and objectives
- Define objectives and acceptance criteria for solutions

How skills are assessed: students may be required to:

- assimilate significant amounts of information, to analyse it (including quantitative analysis) in a way that demonstrates relevant technical knowledge and to draw and support appropriate conclusions.

Applying judgement

Apply professional scepticism and critical thinking

- Recognise bias and varying quality in data and evidence
- Identify assumptions or faults in arguments
- Identify gaps in evidence
- Identify inconsistencies and contradictory information
- Assess interaction of information from different sources
- Exercise ethical judgement

Relate issues to the environment

- Appreciate when more expert help is required
- Identify related issues in scenarios
- Assess different stakeholder perspectives when evaluating options
- Retain an overview of the business issue or scenario
- Appraise corporate responsibility and sustainability issues
- Appraise the effects of alternative future scenarios
- Appraise ethical, public interest and regulatory issues

How skills are assessed: students may be required to:

- make sense of relatively large volumes of data, making judgments on the relevance of data for use in subsequent calculations and discussions;
- reflect on their calculations and the methodology employed and to identify and discuss the implications of calculations; and

- make and justify judgements based on earlier calculations.

Concluding, recommending and communicating

Conclusions

- Apply technical knowledge to support reasoning and conclusions
- Apply professional experience and evidence to support reasoning
- Use valid and different technical skills to formulate opinions, advice, plans, solutions, options and reservations

Recommendations

- Present recommendations in accordance with instructions and defined criteria
- Make recommendations in situations where risks and uncertainty exist
- Formulate opinions, advice, recommendations, plans, solutions, options and reservations based on valid evidence
- Make evidence-based recommendations which can be justified by reference to supporting data and other information
- Develop recommendations which combine different technical skills in a practical situation

Communication

- Present a basic or routine memorandum or briefing note in writing in a clear and concise style
- Present analysis and recommendations in accordance with instructions
- Communicate clearly to a specialist or non-specialist audience in a manner suitable for the recipient
- Prepare the advice, report, or notes required in a clear and concise style

How skills are assessed: students may be required to:

- recommend suitable courses of action in a given situation (financing decisions, dividend decisions, investment appraisal decisions); and
- incorporate advice within a 'business report' format, addressing both the strengths and weaknesses of any recommendations and/or reasons for the rejection of alternatives.

To help you develop your ability to demonstrate competency in each professional skills area, each chapter of this Workbook includes up to four Professional Skills Guidance points.

Each Professional Skills Guidance point focuses on one of the four ACA Professional Skills areas and explains how to demonstrate a particular aspect of that professional skill relevant to the topic being studied. You are advised to refer back to the Professional Skills Guidance points while revisiting specific topics and during question practice.

Chapter 1



Calculating unit costs (Part 1)

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 Identifying direct and indirect costs for cost units

2 Inventory valuation

Summary

Self-test questions

Further question practice

Answers to Interactive questions

Answers to Self-test questions



Introduction

Learning outcomes

- Classify costs as fixed, variable, direct or indirect
- Calculate overhead absorption rates, unit costs and profits/losses from information provided, using:
 - marginal costing
 - absorption costing and reconcile the differences between the costs and profits/losses obtained

The specific syllabus references for this chapter are: 1 b and c.

Syllabus links

A thorough understanding of the valuation of materials inventory will underpin your understanding of inventory valuation for the Accounting syllabus.

Examination context

The context of much of this chapter provides scope for a range of numerical questions. However, you should also be prepared to deal with narrative questions that examine your understanding of the implications of the techniques you are using.

Narrative questions on the pricing of materials issues and on the classification of costs have been popular in past examinations.

In the examination, students may be required to:

- classify costs as direct or indirect
- calculate the prime cost of a cost unit
- calculate the price of materials and the value of inventory using ('first in, first out') FIFO, ('last in, first out') LIFO and average pricing methods

It is important to realise that in this chapter and the next, ideas from Chapter 1 are being applied in determining the cost of a unit of output. The cost object is, therefore, the unit of output and all terms such as direct and indirect are used in that context. It is also essential to appreciate that direct and variable costs and indirect and fixed costs are **not** the same thing. The narrative is as important as the calculations for FIFO, LIFO and weighted average inventory valuations.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	Identifying direct and indirect costs for cost units An important task to be fulfilled by the management information system is to provide unit costs as the basis for a variety of management planning and control activities.	Approach Read quickly through section 1 of Chapter 2 to reinforce your understanding of direct and indirect costs. Spend a little more time thinking about each item in interactive question 1 and use this to	The context of much of this chapter provides scope for a range of numerical questions. However, you should also be prepared to deal with narrative questions that examine your understanding of the implications of the techniques you are using. For example,	IQ1: Direct cost or indirect cost? This question should highlight whether you understand the difference between direct and

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	This can be achieved by analysing costs as direct costs (direct materials, direct labour, direct expenses) or indirect costs (indirect materials, indirect labour, indirect expenses).	test whether you really understand the concepts. Stop and think Are direct costs and variable costs the same thing?	objective test questions may ask you to identify a cost's classification.	indirect costs.
2	<p>Inventory valuation</p> <p>If several different batches of material are purchased, all at different prices, which price should be reported within unit costs for managers to use as the basis of their day-to-day operational and planning decisions?</p> <p>Information providers need mechanisms to systematically record the prices paid for material and the quantities purchased and issued to production or sales.</p>	<p>Section 2 of this chapter is very important and requires you to be actively involved. Do not just skim over all the workings. Get a calculator and check that you understand where each figure in the tabulations comes from. Find a method of laying out the calculations that works for you.</p> <p>Although you will not receive marks for workings in the actual exam, you will need to use a clear layout to achieve the necessary 100% accuracy.</p> <p>Stop and think</p> <p>In times of rapid inflation, why is it important to use up to date prices when reporting costs to the manager who is responsible for determining the selling price of the company's main products or services?</p>	<p>The narrative is as important as the calculations for FIFO, LIFO and weighted average inventory valuations. Objective test questions may require you to pick out correct definitions or statements from a number of statements supplied in a question, or you may have to perform inventory valuation calculations.</p>	<p>IQ2: FIFO</p> <p>A real exam question wouldn't give you a table like this to fill in. However, it's a good question to practise the layout of your workings for a question on FIFO.</p> <p>IQ3: Inventory valuation methods</p> <p>These types of question become easy with practice.</p>

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Identifying direct and indirect costs for cost units



Section overview

- Direct costs are those that can be specifically identified with the cost unit being costed.
- Direct material cost is all material becoming part of the cost unit, unless used in negligible amounts.
- Direct labour cost is all wages paid to labour that can be identified with a specific cost unit.
- Direct expenses are expenses incurred on a specific cost unit, other than direct material and direct labour costs.
- Indirect costs are those that cannot be identified directly with the cost unit being costed.

For the purposes of this chapter and Chapter 3, the cost object is a cost unit (eg, a unit of product, a job, a batch, a unit of service).

2.1 Direct material cost

Direct material is **all material becoming part of the cost unit** (unless used in negligible amounts and/or having negligible cost).

Direct material costs are charged to the cost unit as part of the **prime cost**. Examples of direct material are as follows.

- **Component parts** or other materials purchased for a particular product, service, job, order or process
- **Primary packing materials** like cartons and boxes

Materials used in negligible amounts and/or having negligible cost can be grouped under indirect materials as part of overhead.

2.2 Direct wages or direct labour costs

Direct wages are all **wages paid for labour** (either as basic hours or as overtime) that can be identified with the cost unit.

Direct wages costs are charged to the cost unit as part of the **prime cost**.

Examples of groups of labour receiving payment as direct wages are as follows.

- Workers engaged in **altering** the condition, conformation or composition of the product
- Inspectors, analysts and testers **specifically required** for such production

2.3 Direct expenses

Direct expenses are any expenses that are incurred on a specific cost unit **other than direct material cost and direct wages**.

Direct expenses are charged to the product as part of the **prime cost**. Examples of direct expenses are as follows.

- The cost of special designs, drawings or layouts for a particular job
- The hire of tools or equipment for a particular job

2.4 Indirect costs

Indirect costs or overheads are those costs that cannot be traced in full to a specific cost unit.

For example, a garage carries out a repair job on a customer's car.

- The direct material cost of the job will include the replacement parts used.
- The direct labour cost will be wages paid to the mechanics who carried out the work. The labour is treated as a direct cost in this case, even if the mechanics are paid a fixed amount each period. This is because it is possible to measure exactly how long each person worked on the repair, and their hourly rate of pay.
- The indirect costs of the repair job will include a share of the overhead costs incurred in the garage, such as the rent, the buildings insurance, the depreciation of the garage equipment and so on. These costs cannot be traced to any single job worked on during the period.

For example, a beauty salon carries out a treatment for a customer.

- The direct material cost of the treatment will include the treatment materials, such as a face mask.
- The direct labour cost will be wages paid to the beauticians who carried out the treatment. The labour is treated as a direct cost in this case, even if the beauticians are paid a fixed amount each period. This is because it is possible to measure exactly how long each person worked on the treatment, and their hourly rate of pay.
- The indirect costs of the treatment will include a share of the overhead costs incurred in the salon, such as the rent, the buildings insurance, the salon cleaning costs and so on. These costs cannot be traced to any single treatment worked on during the period.

Try the interactive question below to ensure you have understood the principle of how to distinguish a direct cost from an indirect cost.



Interactive question 1: Direct cost or indirect cost?

A car repair in a garage was worked on in overtime hours, due to an unusually large number of repairs being booked into the garage that day.

Indicate whether each of the following costs would be classified as a direct cost or an indirect cost of that particular car repair in a garage.

Cost incurred	Direct or indirect?
The salary of the garage’s accountant	<input type="text"/>
The cost of heating the garage	<input type="text"/>
A can of engine oil used in the repair	<input type="text"/>
A smear of grease used in the repair	<input type="text"/>
An overtime premium paid to the mechanic carrying out the repair	<input type="text"/>
An idle time payment made to the mechanic while waiting for a delivery of parts for a number of jobs	<input type="text"/>
The wages of the supervisor overseeing the mechanic carrying out the repair	<input type="text"/>

See **Answer** at the end of this chapter.

2.5 Direct and indirect costs: some further points

There are a few possible misconceptions about direct and indirect costs that should be clarified at this stage.

- Direct costs are not necessarily bigger in size than indirect costs.** In highly-automated service industries, direct materials and direct labour costs are likely to be very small, relative to overhead costs. The relative size of direct and indirect costs per unit of output varies according to the type of output, the industry, the technology, etc.

- (b) **Indirect costs are not less important than direct costs.** Although they cannot be directly attributed to individual units of output or to individual jobs, they represent expenditure on resources that are essential for the units to be made or the jobs to be done. In the example of the garage repair job, the rent of the garage is an indirect cost, but the rental cost represents a share of the use of the garage space, without which the job could not have been done.
- (c) **It is easy to confuse fixed and variable costs with indirect and direct costs.** A direct cost is often also a variable cost: for example, the cost of raw materials that goes into making a unit of product is both a direct cost and a variable cost. However, a direct cost may be a fixed cost rather than a variable cost. For example, the direct cost of the labour employed to do a certain type of work is a fixed cost to the business if the employees are paid a fixed amount of wages or salary regardless of the amount of work they do. Similarly, an indirect cost may be a variable cost. For example, the cost of heating in a manufacturing plant may rise as more hours are worked. The cost of heating cannot be directly attributed to an individual job or unit of output. But, it is a cost that rises with the level of activity, and is a variable cost. Variable indirect costs are more commonly referred to as **variable overheads**.

3 *Inventory valuation*



Section overview

- The pricing of issues of inventory items and the valuation of closing inventory have a direct effect on the calculation of profit. Several different methods can be used in practice.
- With FIFO all issues are priced at the cost of the earliest delivery remaining in inventory.
- With LIFO all issues are priced at the cost of the most recent delivery remaining in inventory.
- The cumulative weighted average pricing method calculates a weighted average price for all units in inventory whenever a new delivery of materials is received into store.
- The periodic weighted average pricing method calculates a single weighted average price at the end of the period. The average is based on the opening inventory plus all units received in the period.
- Each method of inventory valuation usually produces different figures for the value of closing inventories and the cost of material issues. Therefore, profit figures using the different inventory valuations are usually different.

4.1 Valuing inventory in financial accounts

You may be aware from your studies of Accounting that, for financial accounting purposes, inventories are valued at the **lower of cost and net realisable value**. In practice, inventories will probably be valued at cost in the store's records throughout the course of an accounting period. Only when the period ends will the value of the inventory in hand be reconsidered so that items with a net realisable value below their original cost will be revalued downwards, and the inventory records altered accordingly.

4.2 Charging units of inventory to cost of production or cost of sales

It is important to be able to distinguish between the way in which the physical items in inventory are actually issued and the way in which inventory is costed. In practice a storekeeper may issue goods in the following way.

- The oldest goods first
- The latest goods received first
- Randomly
- Those that are easiest to reach

By comparison, the cost of goods issued must be determined on a **consistently applied basis**, and must ignore the likelihood that the materials issued will be costed at a price different from the amount paid for them.

This may seem a little confusing at first, and it may be helpful to explain the point further by looking at an example.

4.3 Example: Inventory valuation

Suppose that there are three units of a particular material in inventory.

Units	Date received	Purchase cost
A	June 20X1	£100
B	July 20X1	£106
C	August 20X1	£109

In September, one unit is issued to production. As it happened, the physical unit actually issued was B. The accounting department must put a value or cost on the material issued, but the value would not be the cost of B, £106. The principles used to value the materials issued are not concerned with the actual unit issued, A, B, or C. However, the accountant may choose to make one of the following assumptions.

- The unit issued is valued as though it were the earliest unit received into inventory, ie, at the purchase cost of A, £100. This valuation principle is called **FIFO**, or **first in, first out**.
- The unit issued is valued as though it were the most recent unit received into inventory, ie, at the purchase cost of C, £109. This method of valuation is **LIFO**, or **last in, first out**.
- The unit issued is valued at an **average** price of A, B and C. The three units cost a total of £315, an average of £105 each.

4.4 Pricing methods in inventory valuation

In the following sections we will consider each of the pricing methods detailed above, using the following transactions to illustrate the principles in each case.

Transactions during May 20X6

	Quantity	Unit cost	Total cost	Market value per unit on date of transaction
	Units	£	£	£
Opening balance, 1 May	100	2.00	200	
Receipts, 3 May	400	2.10	840	2.11
Issues, 4 May	200			2.11
Receipts, 9 May	300	2.12	636	2.15
Issues, 11 May	400			2.20
Receipts, 18 May	100	2.40	240	2.40
Issues, 20 May	100			2.42
Closing balance, 31 May	200			2.45
			<u>1,916</u>	



4.5 FIFO (first in, first out)

Definition

FIFO (first in, first out): A method of pricing materials based on the cost of the oldest units held regardless of the sequence in which the issue of the materials takes place.

FIFO assumes that materials are issued out of inventory in the order in which they were delivered into inventory issues are priced at the cost of the earliest delivery remaining in inventory.

Context example: Context example: FIFO

Using **FIFO**, the cost of issues and the closing inventory value of the transactions in section 2.4 would be as follows.

Date of issue	Quantity issued	Value		
	Units		£	£
4 May	200	100 b/f at £2	200	
		100 at £2.10	<u>210</u>	
				410
11 May	400	300 at £2.10	630	
		100 at £2.12	<u>212</u>	
				842
20 May	100	100 at £2.12		<u>212</u>
Cost of issues				1,464
Closing inventory	200	100 at £2.12	212	
		100 at £2.40	<u>240</u>	
				<u>452</u>
				<u>1,916</u>

Using a tabular format, as below, is a practical way of tracking items when carrying out a FIFO calculation:

	£2.00	£2.10	£2.12	£2.40	Total
b/f	100				100
Receipt 3 May		400			400
Issue 4 May	(100)	(100)			(200)
Receipt 9 May			300		300
Issue 11 May		(300)	(100)		(400)
Receipt 18 May				100	100
Issue 20 May			<u>(100)</u>		<u>(100)</u>
	=	=	<u>100</u>	<u>100</u>	<u>200</u>

Notes

The cost of materials issued plus the value of closing inventory equals the cost of purchases plus the value of opening inventory (£1,916).

The market price of purchased materials is rising dramatically. In a period of inflation, there is a tendency with FIFO for materials to be issued at a cost lower than the current market value, although closing inventories tend to be valued at a cost approximating to current market value.

4.6 Advantages and disadvantages of the FIFO method

Advantages	Disadvantages
It is a logical pricing method, which probably represents what is physically happening: in practice the oldest inventory is likely to be used first.	FIFO can be cumbersome to operate because of the need to identify each batch of material separately.
It is easy to understand and explain to managers.	Managers may find it difficult to compare costs and make decisions when they are charged with varying prices for the same materials.
The inventory valuation can be near to a valuation based on replacement cost.	In a period of high inflation, inventory issue prices will lag behind current market value.



Interactive question 2: FIFO

Complete the table below in as much detail as possible using the information from the last worked example.

Date	Receipts						Inventory		
	Quantity	Unit price (£)	Amount (£)	Quantity	Unit price (£)	Amount (£)	Quantity	Unit price (£)	Amount (£)

Date	Receipts						Inventory		
	Quantity	Unit price (£)	Amount (£)	Quantity	Unit price (£)	Amount (£)	Quantity	Unit price (£)	Amount (£)

See **Answer** at the end of this chapter.

4.7 LIFO (last in, first out)



Definition

LIFO (last in, first out): A method of pricing materials based on the cost of the newest units held regardless of the sequence in which the issue of the materials takes place.

LIFO assumes that materials are issued out of inventory in the reverse order from that in which they were delivered.



Context example: Context example: LIFO

Using LIFO, the cost of issues and the closing inventory value of the transactions in the section above called ‘Pricing methods in inventory valuation’ would be as follows.

Date of issue	Quantity issued		Valuation	
	Units		£	£
4 May	200	200 at £2.10		420
11 May	400	300 at £2.12	636	
		100 at £2.10	<u>210</u>	
				846
20 May	100	100 at £2.40		<u>240</u>
Cost of issues				1,506
Closing inventory	200	100 at £2.10	210	
		100 at £2.00	<u>200</u>	

Date of issue	Quantity issued	Valuation		
	Units		£	£
				410
				<u>1,916</u>

A tabular format similar to that in section 2.5 can also be used in section 2.7.

Notes

The cost of materials issued plus the value of closing inventory equals the cost of purchases plus the value of opening inventory (£1,916).

In a period of inflation there is a tendency with **LIFO** for the following to occur.

- Materials are issued at a price that approximates to current market value.
- Closing inventories become undervalued when compared to market value.

4.8 Advantages and disadvantages of the LIFO method

Advantages	Disadvantages
Inventories are issued at a price which is close to current market value.	The method can be cumbersome to operate because it sometimes results in several batches being only part-used in the inventory records before another batch is received.
Managers are continually aware of recent costs when making decisions, because the costs being charged to their department or products will be current costs.	LIFO is often the opposite of what is physically happening and can therefore be difficult to explain to managers.
	As with FIFO, decision making can be difficult because of the variations in prices.

4.9 Cumulative weighted average pricing



Definition

Average cost: Defined by CIMA as a method 'used to price issues of goods or materials at the weighted average cost of all units held.' (*CIMA Official Terminology, 2005*)

The cumulative weighted average pricing method calculates a **weighted average price** for all units in inventory. Issues are priced at this average cost, and the balance of inventory remaining would have the same unit valuation. The average price is determined by dividing the total cost by the total number of units.

A new weighted average price is calculated **whenever a new delivery of materials is received into store**. This is the key feature of cumulative weighted average pricing.



Context example: Context example: Cumulative weighted average pricing

Using cumulative weighted average pricing, issue costs and closing inventory values of the transactions in section 2.4 would be as follows.

Date	Received Units	Issued Units	Balance Units	Total Inventory value	Unit cost	
Opening inventory			100	200	2.00	
3 May	400			<u>840</u>	2.10	
			* 500	1,040	2.08	
4 May		200		<u>(416)</u>	2.08	416
			300	624	2.08	
9 May	300			<u>636</u>	2.12	
			* 600	1,260	2.10	
11 May		400		<u>(840)</u>	2.10	840
			200	420	2.10	
18 May	100			<u>240</u>	2.40	
			* 300	660	2.20	
20 May		100		<u>(220)</u>	2.20	220
Cost of issues						1,476
Closing inventory value			200	440	2.20	<u>440</u>
						<u>1,916</u>

* A new inventory value per unit is calculated whenever a new receipt of materials occurs.

Notes

The cost of materials issued plus the value of closing inventory equals the cost of purchases plus the value of opening inventory (£1,916).

In a period of inflation, using the cumulative weighted average pricing system, the value of material issues will rise gradually, but will tend to lag a little behind the current market value at the date of issue. Closing inventory values will also be a little below current market value.

4.10 Advantages and disadvantages of cumulative weighted average pricing

Advantages	Disadvantages
Fluctuations in prices are smoothed out, making it easier to use the data for decision making.	The resulting issue price is rarely an actual price that has been paid, and can run to several decimal places.
It is easier to administer than FIFO and LIFO, because there is no need to identify each batch separately.	Prices tend to lag a little behind current market values when there is gradual inflation.

One of the professional skills assessed in the ACA exams is the ability to 'appraise the effects of alternative future scenarios'. For example, a question might ask about the differences between FIFO, LIFO and cumulative weighted average pricing.



Professional skills focus: Assimilating and using information

One of the professional skills assessed in the ACA exams is the ability to 'interpret information provided in various formats'. This could include tables such as the one in the next activity.



Interactive question 3: Inventory valuation methods

Shown below is an extract from records for inventory item number 988988.

Date	Qty	Receipts Value £	Total £	Qty	Issues Value	Total	Qty	Balance Value	Total £
5 June							30	2.50	75
8 June	20	3.00	60						
10 June				10		A			
14 June				20		B			
18 June	40	2.40	96						
20 June				6		C			D

The values that would be entered on the stores record for A, B, C and D in a cumulative weighted average pricing system would be:

A = £

B = £

C = £

D = £

The values that would be entered on the stores record for A, B, C and D in a LIFO system would be:

A = £

B = £

C = £

D = £

See **Answer** at the end of this chapter.

4.11 Periodic weighted average pricing


This average method differs from the cumulative weighted average method. Instead of calculating a new inventory value per unit whenever a receipt occurs, a single average is calculated at the end of the period based on all purchases for the period. **Unless stated to the contrary, assume the cumulative method is required in an exam question.**



Context example: Context example: Periodic weighted average pricing

Using periodic weighted average pricing, the issue costs and closing inventory of the transactions in section 2.4 would be as follows.

This average price is used to value all the units issued and the units in the closing inventory.

	£
Cost of issues = 700 units × £2.129	1,490
 Closing inventory value = 200 units × £2.129	426
	<u>1,916</u>

Notice that once again the cost of materials issued plus the value of closing inventory equals the cost of purchases plus the value of opening inventory (£1,916).

4.12 Inventory valuation and profitability



Professional skills focus: Structuring problems and solutions

One of the professional skills assessed in the ACA exams is the ability to 'identify a range of possible solutions based on analysis'. Different methods of inventory valuation will provide different profit figures.

Each method of inventory valuation usually produces different figures for the value of closing inventories and the cost of material issues. A summary of the valuations based on the transactions in section 2.4 is as follows.

Valuation method	Closing inventory value	Cost of issues	Total
	£	£	£
FIFO (section 2.5)	452	1,464	1,916
LIFO (section 2.7)	410	1,506	1,916
Cumulative weighted average (section 2.9)	440	1,476	1,916
Periodic weighted average (section 2.11)	426	1,490	1,916

Since material costs affect the cost of production, and the cost of production works through eventually into the cost of sales (which is also affected by the value of closing inventories), it follows that **different methods of inventory valuation will provide different profit figures**.

The following example will help to illustrate the point.



Worked example: Inventory valuation and profitability

On 1 November 20X2, Delilah's Dresses Ltd held three pink satin dresses with orange sashes, designed by Freda Swoggs. These were valued at £120 each. During November 20X2, 12 more of the dresses were delivered as follows.

Date	Dresses received	Purchase cost per dress
10 November	4	£125
20 November	4	£140

Date	Dresses received	Purchase cost per dress
25 November	4	£150

A number of the pink satin dresses with orange sashes were sold during November as follows.

Date	Dresses sold	Sales price per dress
14 November	5	£200
21 November	5	£200
28 November	1	£200

Requirements

- Calculate the gross profit from selling the pink satin dresses with orange sashes in November 20X2, applying the following principles of inventory valuation.
 - FIFO
 - LIFO
 - Cumulative weighted average pricing
- Calculate gross profit using the formula: gross profit = (sales - (opening inventory + purchases - closing inventory)).

Solution

(a)

Date	Cost of sales	Total £	Closing inventory £
14 November	3 units × £120 + 2 units × £125	610	
21 November	2 units × £125 + 3 units × £140	670	
28 November	1 unit × £140	140	
Closing inventory	4 units × £150		600
		<u>1,420</u>	<u>600</u>

(b)

Date	Cost of sales	Total £	Closing inventory £
14 November	4 units × £125 + 1 unit × £120	620	
21 November	4 units × £140 + 1 unit × £120		

Date	Cost of sales	Total £	Closing inventory £
		680	
28 November	1 unit × £150	150	
Closing inventory	3 units × £150		
	+ 1 unit × £120		
			<u>570</u>
		<u>1,450</u>	<u>570</u>

(c)

	Units	Unit cost £	Balance in inventory £	Cost of sales £	Closing inventory £
1 November	3	120.00	360		
10 November	<u>4</u>	125.00	<u>500</u>		
	7	122.86	860		
14 November	<u>5</u>	122.86	<u>614</u>	614	
	2		246		
20 November	<u>4</u>	140.00	<u>560</u>		
	6	134.33	806		
21 November	<u>5</u>	134.33	<u>672</u>	672	
	1		134		
25 November	<u>4</u>	150.00	<u>600</u>		
	5	146.80	734		
28 November	<u>1</u>	146.80	<u>147</u>	<u>147</u>	
30 November	<u>4</u>	146.80	<u>587</u>	<u>1,433</u>	<u>587</u>

3

Profitability	FIFO £	LIFO £	Weighted average £
Opening inventory	360	360	360
Purchases	<u>1,660</u>	<u>1,660</u>	<u>1,660</u>
	2,020	2,020	2,020
Closing inventory	<u>600</u>	<u>570</u>	<u>587</u>
Cost of sales	1,420	1,450	1,433
Sales (11 × £200)	<u>2,200</u>	<u>2,200</u>	<u>2,200</u>
Gross profit	<u>780</u>	<u>750</u>	<u>767</u>

4.13 Profit differences

In this example, different inventory valuation methods produced different costs of sale and hence different gross profits. As opening inventory values and purchase costs are the same for each method, the different costs of sale are due to different closing inventory valuations. The differences in gross profits therefore equal the differences in closing inventory valuations.

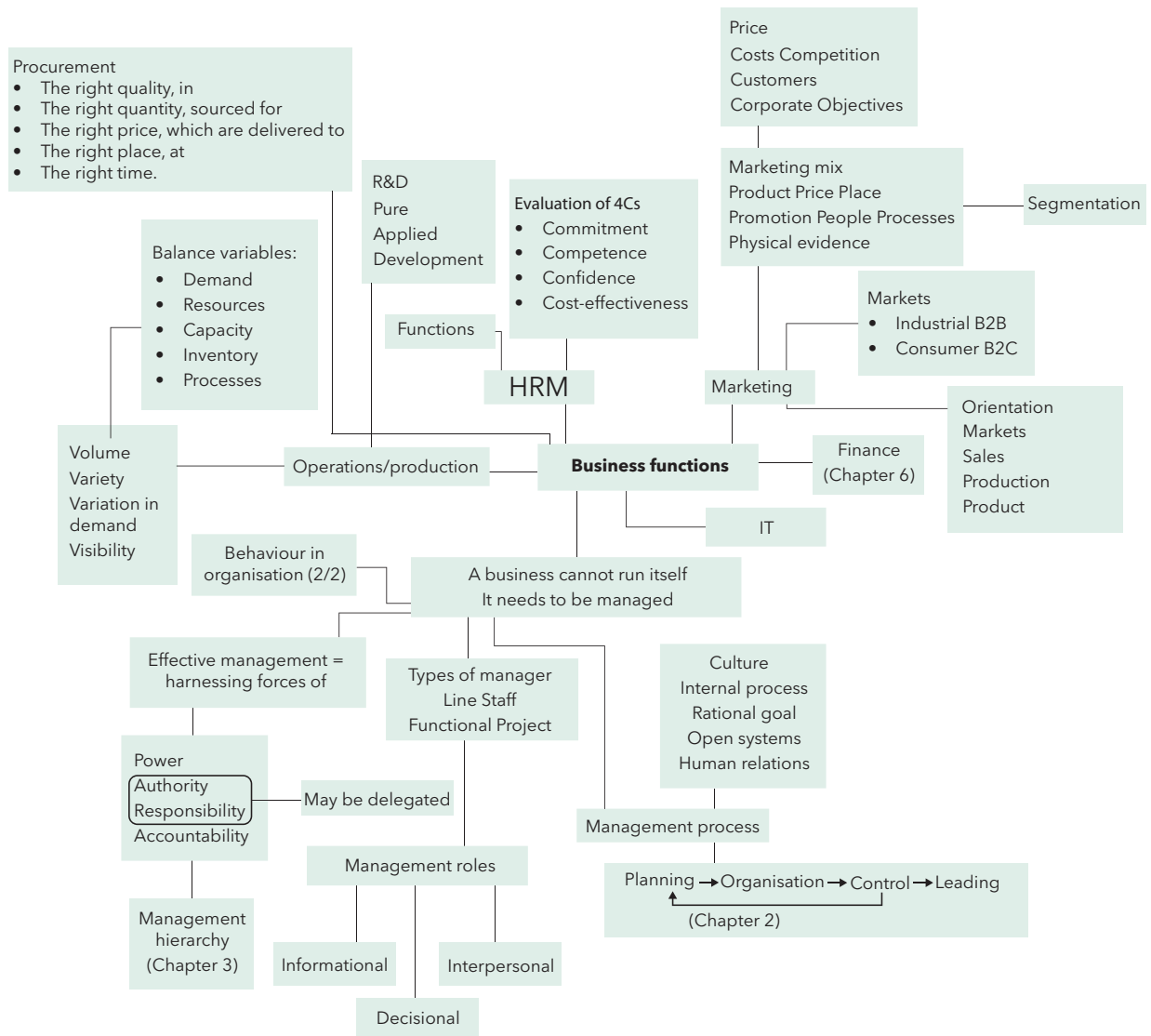
The profit differences are only **temporary**. In the example, the opening inventory in December 20X2 will be £600, £570 or £587, depending on the inventory valuation method used. Different opening inventory values will affect the cost of sales and profits in December, so that in the long run, inequalities in costs of sales each month will even themselves out.



Professional skills focus: Assimilating and using information

One of the professional skills assessed in the ACA exams is the ability to 'Identify and prioritise key issues and stay on task'. For questions on inventory valuation, stay on task by reading the questions carefully to establish whether the closing inventory, cost of issues or profit are required.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, complete the following knowledge diagnostic and check you are able to confirm you possess the following essential learning from this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.






Confirm your learning	
1.	Would materials used in negligible amounts could be classed as direct or indirect materials? (Topic 1)
2.	Can you give an example of a direct labour cost? (Topic 1)
3.	Can you give an example of a direct expense? (Topic 1)
4.	What are the advantages and disadvantages of the FIFO, LIFO and cumulative weighted average pricing methods? (Topic 2)
5.	Under the cumulative weighted average pricing method, when is a new weighted average price calculated? (Topic 2)


2 Chapter Self-test question practice

Aim to complete all the self-test questions at the end of this chapter. Once completed, attempt all the questions in the **Calculating unit costs (Part 1)** chapter of the **Management Information** Question Bank. Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can move on to the next chapter.

Self-test questions

Answer the following questions.

- Which **two** of the following are cost objects?
 - A A packing machine
 - B The factory canteen
 - C Direct materials for production
 - D Annual salary of the chief accountant
 -  A telephone bill
- Which **two** of the following are classified as indirect costs of individual units of output or of individual projects?
 - A The cost of overtime worked specifically to complete a one-off project
 - B The depreciation of a machine on an assembly line
 - C Primary packing materials, eg, cartons and boxes
 -  The hire of maintenance tools or equipment for a factory
- Which one of the following would be classified as an indirect cost of individual batches of output, units of service or of individual projects of the organisation concerned?
 - A The cost of sugar used for a batch of cakes in a bakery
 - B The lease rental cost of a leased car used by a site foreman travelling to a specific construction project
 - C The accountant's salary in a factory
 -  The cost of drinks served on an intercity train journey
- When costing cost units, wage payments for idle time within a production department are classified as:
 - A Direct labour cost
 - B Prime cost
 - C Administration overhead
 -  Factory overhead
- A retailer currently uses the LIFO method to value its inventory of goods for sale. If the retailer decides instead to use the FIFO method, in a **period of rising prices**:
 - A The closing inventory value will be lower and the gross profit will be lower
 - B The closing inventory value will be lower and the gross profit will be higher
 - C The closing inventory value will be higher and the gross profit will be lower
 -  The closing inventory value will be higher and the gross profit will be higher
- A wholesaler had an opening inventory of 750 units of geronimos valued at £80 each on 1 March. The following receipts and sales were recorded during March.

4 March	Received 180 units at a cost of	£85 per unit
18 March	Received 90 units at a cost of	£90 per unit
 24 March	Sold 852 units at a price of	£110 per unit

Using the weighted average cost method of valuation, what was the cost of geronimos sold on 24 March? (To the nearest £.)

 - A £35,320
 - B £38,016

- C £38,448
- D £69,660

At the beginning of Week 10 there were 400 units of component X held in the stores. 160 of these components had been purchased for £5.55 each in Week 9 and 240 had been purchased for £5.91 each in Week 8.

On day 3 of Week 10 a further 120 components were received into stores at a purchase cost of £5.96 each.

The only issue of component X occurred on day 4 of Week 10, when 150 units were issued to production.

Using the FIFO valuation method, what was the value of the closing inventory of component X at the end of Week 10?

- A £1,980.45
- B £2,070.15
- C £2,135.10
- D £2,200.55

A wholesaler had an opening inventory of 330 units of product T valued at £168 each on 1 April. The following receipts and sales were recorded during April.

4 April	Received 180 units at a cost of	£174 per unit
18 April	Received 90 units at a cost of	£186 per unit
24 April	Sold 432 units at a price of	£220 per unit

Using the LIFO valuation method, what was the gross profit earned from the units sold on 24 April?

- A £16,350
- B £18,120
- C £18,520
- D £19,764

Are the following statements true or false?

	True or false?
Using LIFO, managers are continually aware of recent costs when making decisions, because the costs being charged to their departments or products will be current costs.	<input type="text"/>
FIFO lets managers value issues at current prices in a period of high inflation.	<input type="text"/>
The use of the cumulative average pricing method of inventory valuation is easier to administer than FIFO and LIFO because there is no need to identify each batch separately.	<input type="text"/>

A business buys and sells boxes of item J. The transactions for the latest quarter are shown below.

Opening inventory	400 boxes valued at £1,000
-------------------	----------------------------

	Purchases		Sales
	Boxes	Value £	Boxes
July	1,000	2,600	1,100

	Purchases		Sales
	Boxes	Value	Boxes
August	1,200	3,300	900
September	1,000	3,000	800

The business values its inventories using a periodic weighted average price calculated at the end of each quarter.

Complete the sentence.

To the nearest £, the value of the inventory at the end of September is £ .

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Cost incurred	Direct or indirect?
The salary of the garage's accountant	Indirect
The cost of heating the garage	Indirect
A can of engine oil used in the repair	Direct
A smear of grease used in the repair	Indirect
An overtime premium paid to the mechanic carrying out the repair	Indirect
An idle time payment made to the mechanic while waiting for a delivery of parts for a number of jobs	Indirect
The wages of the supervisor overseeing the mechanic carrying out the repair	Indirect

The accountant's salary and the heating are both overheads, which means they are indirect costs.

The can of engine oil cost can be directly attributed to this particular repair.

The smear of grease is negligible and would not be recorded separately as a direct cost.

The overtime was worked due to a generally heavy workload. This particular repair had not caused the overtime premium to be incurred. The cost is indirect and must be shared over all the repair jobs carried out.

The idle time payment cannot be identified with any particular repair job. Similarly, the supervisor is overseeing all repair jobs being undertaken, so their wages are an indirect cost for this particular job.

Answer to Interactive question 2

Date	Receipts						Inventory		
	Quantity	Unit price (£)	Amount (£)	Quantity	Unit price (£)	Amount (£)	Quantity	Unit price (£)	Amount (£)
1.5.X6							100	2.00	200.00
3.5.X6	400	2.10	840.00				100	2.00	200.00
							<u>400</u>	2.10	<u>840.00</u>
							500		1,040.00
4.5.X6				100	2.00	200.00			
				100	2.10	210.00	300	2.10	630.00

Date	Receipts						Inventory		
	Quantity	Unit price (£)	Amount (£)	Quantity	Unit price (£)	Amount (£)	Quantity	Unit price (£)	Amount (£)
9.5.X6	300	2.12	636.00				300	2.10	630.00
							<u>300</u>	2.12	<u>636.00</u>
							600		1,266.00
11.5.X6				300	2.10	630.00			
				100	2.12	212.00	200	2.12	424.00
18.5.X6	100	2.40	240.00				200	2.12	424.00
							<u>100</u>	2.40	<u>240.00</u>
							300		664.00
20.5.X6				100	2.12	212.00	100	2.12	212.00
							<u>100</u>	2.40	<u>240.00</u>
31.5.X6							200		452.00

Answer to Interactive question 3

A = £

B = £

C = £

D = £

WORKING

Cumulative weighted average price working

			£	
8 June	Inventory balance =	30	units × £2.50	75
		<u>20</u>	units × £3.00	<u>60</u>
		<u>50</u>		<u>135</u>
			Weighted average price	= 135/50
				= 2.70

				£
10 June	Issues =	10	units × £2.70	<u>£27</u>
14 June	Issues =	20	units × £2.70	<u>£54</u>
18 June	Inventory balance = remaining	20	units × £2.70	54
	receipts	<u>40</u>	units × £2.40	<u>96</u>
		<u>60</u>		<u>150</u>
			Weighted average price	= 150/60
				= 2.50
20 June	Issues =	6	units × £2.50	<u>£15</u>
	Inventory balance =	54	units × £2.50	<u>135</u>

A = £

B = £

C = £

D = £

WORKING

LIFO working

				£
10 June		10	units × £3.00	<u>30.00</u>
4 June	Issues	10	units × £3.00 =	30.00
		10	units × £2.50 =	<u>25.00</u>
				<u>55.00</u>
20 June	Issues:	6	units × £2.40 =	<u>14.40</u>
	Balance:	34	units × £2.40	81.60
		<u>20</u>	units × £2.50	<u>50.00</u>
		<u>54</u>		<u>131.60</u>

Answers to Self-test questions

1 Correct answer(s):

- A A packing machine
- B The factory canteen

It is possible to ascertain the cost of these first two cost objects.

The other three items are costs that might be attributed to a particular cost object, but they are not cost objects in themselves.

2 Correct answer(s):

- B The depreciation of a machine on an assembly line
- D The hire of maintenance tools or equipment for a factory

The cost of overtime worked specifically to complete a one-off project (Option A) is direct labour. Primary packing materials, eg, cartons and boxes, (Option C) are direct materials.

3 Correct answer(s):

- C The accountant's salary in a factory

The accountant's salary is an indirect cost because it cannot be traced to a specific cost unit. It would be classified as an administration overhead.

All of the other costs can be traced to a specific cost unit: the cost of sugar would be a direct ingredients' cost of a specific batch of cakes; the lease rental cost would be a direct cost of a construction project and the cost of drinks served would be a direct cost of a particular train journey.

4 Correct answer(s):

- D Factory overhead

Idle time is usually treated as an overhead; in this case it is within the production department and is therefore a factory overhead.

5 Correct answer(s):

- D The closing inventory value will be higher and the gross profit will be higher

The FIFO method prices issues from inventory at the cost of the earliest delivery remaining in inventory.

The closing inventory will therefore be valued at the higher prices paid.

The charge to cost of sales will be lower than with LIFO, therefore the gross profit will be higher.

6 Correct answer(s):

- D £69,660

Weighted average cost per unit:		£
750	units × £80	60,000
180	units × £85	15,300
90	units × £90	8,100
<u>1,020</u>		<u>83,400</u>

Weighted average cost per unit	= £83,400/1,020
	= £81.76
Cost of units sold on 24 March	= £81.76 × 852 units
	= £69,660

7 Correct answer(s):

C £2,135.10

Components issued on Day 4 = 150 from Week 8 receipts

Closing inventory Week 10:

			£
Remaining	90	Components from week 8 × £5.91	531.90
	160	Components from week 9 × £5.55	888.00
	<u>120</u>	Components from week 10 × £5.96	<u>715.20</u>
	<u>370</u>		<u>2,135.10</u>

8 Correct answer(s):

D £19,764

The LIFO method uses the cost of the most recent batches first.

Cost of units sold on 24 April:

			£
90	units × £186		16,740
180	units × £174		31,320
<u>162</u>	units × £168		<u>27,216</u>
<u>432</u>			<u>75,276</u>

Sales revenue = 432 units × £220	95,040
Less cost of units sold	<u>75,276</u>
Gross profit	<u>19,764</u>

	True or false?
Using LIFO, managers are continually aware of recent costs when making decisions, because the costs being charged to their departments or products will be current costs.	True
FIFO lets managers value issues at current prices in a period of high inflation.	False
The use of the cumulative average pricing method of inventory valuation is easier to administer than FIFO and LIFO because there is no need to identify each batch separately.	True

FIFO lets managers value issues at current prices in a period of high inflation is incorrect. Under FIFO, inventory issues are valued at the cost of the earliest delivery remaining in inventory. In times of inflation, this will mean that issue prices will be lower than current prices.

- 9 To the nearest £, the value of the inventory at the end of September is £ 2,200 .

Total inventory available during quarter:

	Boxes	Value £
Opening inventory	400	1,000
Purchases: July	1,000	2,600
August	1,200	3,300
September	<u>1,000</u>	<u>3,000</u>
	<u>3,600</u>	<u>9,900</u>

Periodic weighted average price	= £9,900/3,600
	= £2.75 per box
Closing inventory	= 3,600 – (1,100 + 900 + 800)
	= 800 boxes
Value of closing inventory	= 800 × £2.75
	= £2,200



Appendix

Tax Tables FA2020

Syllabus area: Administration

SUBMISSION DATES

Submission dates for 2020/21 personal self-assessment tax returns

	Later of: 31 January 2022
Return filed online	3 months from the date of issue of return
	Later of: 31 October 2021
Paper returns	3 months from the date of issue of return

Submission dates for corporation tax returns

Must be filed by 12 months from the end of the period of account.

Submission dates for PAYE information: Real Time Information

Information	Filing date
Full Payment Submission (FPS)	On or before the day the employee is paid
P60 (to employees)	31 May following the tax year end
P11D	6 July following the tax year end

PAYMENT DATES

Payment dates for income tax

Payment	Filing date
First interim payment ⁽¹⁾	31 January in the tax year
Second interim payment ⁽¹⁾	31 July following the tax year end
Balancing payment	31 January following the tax year end

(1) Interim payments are not required if the tax paid by assessment for the previous year was less than:

£1,000; or

20% of the total tax liability (income tax and Class 4)

Payment dates for capital gains tax

Capital gains tax is payable by 31 January following the tax year end.

Payment dates for corporation tax

	Nine months and one day after the end of an accounting period
Corporation tax	
Corporation tax by instalments – large companies	The 14 th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14 th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Payment dates for VAT

	Due date
Electronic payment	7 calendar days after the last day of the month following the end of the return period
Direct debit payment	Collected automatically 3 working days after electronic payment due date

MAIN PENALTY PROVISIONS

PENALTIES FOR INCORRECT RETURNS

The penalties are a percentage of the potential lost revenue

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure	Minimum penalty with prompted disclosure
Careless action	30%	Nil	15%
Deliberate but not concealed action	70%	20%	35%
Deliberate and concealed action	100%	30%	50%

PENALTIES FOR FAILURE TO NOTIFY

Failures to notify chargeability to tax, or liability to register for tax that leads to a loss of tax will result in a penalty. The penalties are a percentage of the potential lost revenue.

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure		Minimum penalty with prompted disclosure	
Deliberate and concealed action	100%	30%		50%	
Deliberate but not concealed action	70%	20%		35%	
		>12m	<12m	>12m	<12m
Any other case	30%	10%	Nil	20%	10%

COMPANIES: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability within 12 months of end of accounting period	See above: penalties for failure to notify

Corporation tax: penalties for late filing of a corporation tax return

Offence	Penalty ⁽¹⁾
Late return, up to 3 months late	£100 fixed penalty, or £500 for persistent failure
Return more than 3 months late	£200 fixed penalty, or £1,000 for persistent failure
Return filed more than 18 months but less than 24 months after end of return period	Tax geared penalty of 10% of tax unpaid 18 months after end of return period
Return filed more than 24 months after end of return period	Tax geared penalty of 20% of tax unpaid 18 months after end of return period

(1) The tax geared penalty is charged in addition to the fixed penalty but only one of each type of penalty is charged.

INDIVIDUALS: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability by 5 October following tax year end	See above: penalties for failure to notify
Late payment of income tax or capital gains tax: ⁽¹⁾	
Unpaid 30 days after payment due date	5% of tax unpaid
Unpaid 6 months after payment due date	Further 5% of tax unpaid
Unpaid 12 months after payment due date	Further 5% of tax unpaid

(1) Late payment penalties do not apply to payments on account.

Income tax and CGT: penalties for late filing of a self-assessment return

Offence	Maximum Penalty
Late return	Immediate £100 fixed penalty
Return more than 3 months late	Daily fixed penalties of up to £10 per day for maximum 90 days
Return more than 6 months but less than 12 months late	Further tax geared penalty of 5% of tax due (minimum £300)
Return 12 months late	Further tax geared penalties apply (minimum £300): 100% if deliberate and concealed ⁽¹⁾ 70% if deliberate but not concealed ⁽¹⁾ 5% in all other cases

(1) These tax geared penalties are reduced for disclosure as per penalties for incorrect returns.

PAYE: penalties for late returns/ submissions

Number of employees	Monthly penalty
1 to 9	£100
10 to 49	£200
50 to 249	£300
250 or more	£400

If the form is more than three months late, an additional penalty is due of 5% of the tax and NIC that should have been reported.

Additionally, there is a £300 penalty per late P11D return, with an extra £60 per day charged if the delay continues.

PAYE: penalties for late payment

	No of late payments	% of tax unpaid ⁽¹⁾
	1st	nil
	2 nd , 3 rd & 4 th	1%
	5 th , 6 th & 7 th	2%
	8 th , 9 th & 10 th	3%
Penalties for late payment of in-year PAYE depend on the number of defaults in the tax year	11 th or more	4%
Where a penalty has been imposed and the tax remains unpaid at 6 months		5% ⁽²⁾
Where a penalty has been imposed and the tax		5% ⁽²⁾

remains unpaid at 12 months

(1) The percentage penalty is applied to the total amount that is late in the relevant tax month.

(2) The 6 month and the further 12 month penalties are in addition to the initial penalty for late payment.

VAT: penalties

Offence

Maximum Penalty

Failure to notify liability for registration or change in nature of supplies by person exempted from registration

See above: penalties for failure to notify

VAT: late payment or late filing - default surcharge

Default involving late payment of VAT in the surcharge period⁽¹⁾

Surcharge as a percentage of the VAT outstanding at the due date

First	2% ⁽²⁾
Second	5% ⁽²⁾
Third	10% ⁽³⁾
Fourth	15% ⁽³⁾

(1) Default if late payment of VAT or filing of VAT return and surcharge liability notice issued, but default surcharge only applies on late payment.

(2) No surcharge if it would be less than £400.

(3) Minimum £30 payable.

VAT errors

An error made on a VAT return can be corrected on the next return provided it was not deliberate and does not exceed the greater of:

- £10,000 (net under-declaration minus over-declaration); or
- 1% x net VAT turnover for return period (maximum £50,000)

Alternatively, a 'small' error which is not deliberate may be corrected via the submission of form VAT652. Errors which are not 'small' or errors which are deliberate should be notified to HMRC on form VAT652.

RECORD KEEPING PENALTY

Offence

Maximum Penalty

Failure to keep and retain tax records

£3,000 per tax year / accounting period

INCOME TAX RATES: 2020/21

	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 - £37,500
Higher rate	40%	£37,501 - £150,000
Additional rate	45%	Over £150,000
Savings rates		
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate

	Rate	Taxable income band
Savings higher rate	40%	Otherwise chargeable at higher rate
Savings additional rate	45%	Otherwise chargeable at additional rate
Dividends rates		
Dividend nil rate	0%	First £2,000
Dividend ordinary rate	7.5%	Otherwise chargeable at basic rate
Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	
INCOME TAX RELIEFS		2020/21
Personal allowance		£12,500

CGT RATES

	2020/21
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%

CORPORATION TAX RATES

	FY 2020
Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

NATIONAL INSURANCE CONTRIBUTIONS

	2020/21		
	Annual	Monthly	Weekly
NIC CLASS 1			
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962
Apprentice upper secondary threshold (AUST) for under 25s	£50,000	£4,167	£962
Upper secondary threshold (UST) for under 21s	£50,000	£4,167	£962

	2020/21		
	Annual	Monthly	Weekly
NIC CLASS 1			
Employment allowance (per year, per employer)	£4,000		
Class 1 Primary contributions on earnings between PT & UEL	12%		
Class 1 Primary contributions on earnings above UEL	2%		
Class 1 Secondary contributions on earnings above ST where employee aged 21 or over and not an apprentice under the age of 25	13.8%		
Class 1 Secondary contributions on earnings between ST & AUST for apprentices under the age of 25	0%		
Class 1 Secondary contributions on earnings above AUST for apprentices under the age of 25	13.8%		
Class 1 Secondary contributions on earnings between ST & UST for employees under the age of 21	0%		
Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%		
Class 1A contributions	13.8%		

	2020/21
NIC CLASS 2	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%
VAT	
Standard rate of VAT	20%
Reduced rate of VAT	5%

Syllabus Area: Income Tax & NIC

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 - £37,500
Higher rate	40%	£37,501 - £150,000
Additional rate	45%	Over £150,000
Savings rates		

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate
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Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	

INCOME TAX RELIEFS	2020/21
Personal allowance ⁽¹⁾	£12,500
Marriage allowance ⁽²⁾	£1,250

(1) The personal allowance of any individual with adjusted net income above £100,000 is reduced by £1 for every £2 of adjusted net income above the £100,000 limit.

(2) A spouse or civil partner who is a basic rate taxpayer or who has income of less than the personal allowance is allowed to transfer £1,250 of their personal allowance (ie 10% rounded up to the next £10) to their spouse/civil partner provided the recipient spouse is a basic rate taxpayer.

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO₂ emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

COMPANY VANS, CARS AND FUEL

Van scale charge

No charge applies if there is insignificant private use

£2,792 if van has zero CO₂ emissions and £3,490 if it has CO₂ emissions

Additional £666 if private fuel provided for the van

Company cars - cash equivalent

Zero emissions cars 0% of list price

Company cars - cash equivalent

	2% of list price for cars with a battery range of >130 miles
	5% of list price for cars with a battery range of 70-129 miles
	8% of list price for cars with a battery range of 40-69 miles
Hybrid cars with emissions 1-50g/km	12% of list price for cars with a battery range of 30-39 miles
	14% of list price for cars with a battery range of <30 miles
Other cars	15% of list price for cars emitting 51-54g/km
	16% of list price for cars emitting 55-59g/km
	17% of list price for cars emitting 60-64g/km
	18% of list price for cars emitting 65-69g/km
	19% of list price for cars emitting 70-74g/km
	20% of list price for cars emitting 75-79g/km
	Increased by 1% per 5g/km over the 75g/km relevant threshold

Relevant % is reduced by 2% for cars first registered from 6 April 2020

Capped at 37% of list price (ie emissions of 160g/km or more for cars first registered before 6 April 2020 and 170g/km for cars first registered from 6 April 2020)

Diesel cars that meet the Real Driving Emissions Step 2 (RDE2) standard are treated as above, all other diesel cars have a 4% supplement added to the relevant percentage (subject to 37% cap)

Private fuel provided for company car

£24,500 x company car %

PAYE CODES

L	tax code with personal allowance
M	tax code with personal allowance plus claiming marriage allowance
N	tax code with personal allowance less surrendered marriage allowance
S	income taxed at Scottish rate of income tax
C	income taxed at Welsh rate of income tax
K	total allowances are less than total deductions
T	tax code includes other calculations to work the personal allowance, for example it has been reduced because estimated annual income is more than £100,000

NATIONAL INSURANCE CONTRIBUTIONS

NIC CLASS 1 CONTRIBUTIONS	2020/21		
	Ann ual	Mon thly	We ekly
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962

	2020/21		
NIC CLASS 1 CONTRIBUTIONS	Ann ual	Mon thly	We ekly
Apprentice upper secondary threshold (AUST) for under 25s	£50,000	£4,167	£962
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Class 1 Secondary contributions on earnings above AUST for apprentices under the age of 25	13.8%		
Class 1 Secondary contributions on earnings between ST & UST for employees under the age of 21	0%		
Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%		
Class 1A contributions	13.8%		

	2020/21
NIC CLASS 2 CONTRIBUTIONS	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4 CONTRIBUTIONS	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%

Syllabus area: Capital Gains

	2020/21
Annual exempt amount	£12,300
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%
Basic rate band	£1 – £37,500

Syllabus area: Corporation tax

FY 2020

Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO₂ emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

PAYMENT DATES

Payment dates for corporation tax

Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14 th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14 th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Syllabus area: Value Added Tax

VAT

Standard rate		20%
Reduced rate		5%
Annual registration limit	From 1 April 2017	£85,000
Deregistration limit	From 1 April 2017	£83,000
VAT fraction (standard rated)		1/6

Cash accounting	£
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000
Annual accounting	
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000

Flat rate scheme	
Annual taxable turnover limit (excluding VAT) to join scheme	150,000
Annual total income (including VAT) to leave scheme	230,000



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